



# Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations

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## Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations

By Stephen E. Shay



Stephen E. Shay

Stephen E. Shay is a professor of practice at Harvard Law School. Shay thanks Nell Geiser and Molly Thomas-Jensen from Change to Win for drawing his attention to the Walgreens transaction and Cliff Fleming, Nell Geiser, Steven Rosenthal, Molly Thomas-Jensen, and others who prefer not to be identified for discussions about market activity and helpful comments on earlier drafts.

In this article, Shay describes the principal tax benefits companies seek from expatriating, and he outlines regulatory actions that can be taken without legislative action to materially reduce the tax incentive to expatriate.

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### A. Introduction

The lack of government response to the current wave of tax-motivated corporate expatriations is disheartening.<sup>1</sup> Senate Finance Committee Chair

<sup>1</sup>President Obama has spoken out against corporate expatriations. Treasury Secretary Jacob Lew has written letters to Senate Finance Committee Chair Ron Wyden, D-Ore., House Ways and Means Committee Chair Dave Camp, R-Mich., and ranking members of the congressional taxwriting committees urging immediate legislative action to stop corporate expatriations and calling for a "new sense of economic patriotism." Wyden has also written a *Wall Street Journal* op-ed stating that any legislation will have a May 8, 2014, effective date ("We Must Stop Driving Businesses Out of the Country," *The Wall Street Journal*, May 9, 2014). Sen. Carl Levin, D-Mich., and others have introduced legislation that would make expatriations more difficult to achieve (S. 2360; H.R. 4679). The Obama administration has included a similar proposal in its budget. In a reply to Lew, Finance Committee ranking minority member Orrin G. Hatch, R-Utah, has indicated his willingness to work on a short-term response short of tax reform, while objecting to what he believes are the political overtones of Lew's call for economic patriotism.

Ron Wyden, D-Ore., Sen. Carl Levin, D-Mich., and Rep. Sander Levin, D-Mich., are to be praised for their leadership on this issue; however, in the current political environment there is little reason to believe that a statutory solution will be enacted. One looks in vain at the tax press each day to see what action is being taken, not just talked about, and as of this writing, nothing has been done. This article demonstrates that it is not necessary for Treasury to wait for Congress to act on corporate expatriations.

This article describes the principal tax benefits companies seek from expatriating and outlines regulatory actions that can be taken without legislative action to materially reduce the tax incentive to expatriate. These proposals for regulations are supported by existing statutory authority. They would be good policy and consistent with, or easily integrated with, publicly proposed tax reform proposals.

One of the Treasury secretary's most important responsibilities is the health of the tax system under the laws adopted by Congress. Congress has given Treasury broad and in some cases sweeping authority to adopt regulations, including specific grants of authority that bear on issues at the heart of corporate inversions. The proposals here are just one set of alternatives available to Treasury that could powerfully affect the incentive to expatriate. Others no doubt have improvements to these or other alternatives to propose; however, when a material portion of the U.S. corporate tax base is at risk, doing nothing borders on the irresponsible.

### B. Tax Benefits of Corporate Expatriation

Corporate expatriations afford two principal tax benefits. First, the new foreign parent (or one of its non-U.S. subsidiaries) can strip the U.S. tax base (for example, through distribution of a note from the U.S. group) to achieve cash and book tax savings. Second, the untaxed foreign earnings of former U.S. parent company's controlled foreign corporations can be redeployed for use by non-CFC affiliates, including for group debt reduction and stock buy-backs by the new foreign parent, without causing a taxable deemed repatriation to the former U.S. parent.<sup>2</sup>

<sup>2</sup>In some situations, it may be possible to deny tax benefits from these strategies under existing tax doctrines. I do not  
(Footnote continued on next page.)

The financial statement and cash tax savings that derive from introducing substantial intercompany debt into the U.S. group to strip the U.S. tax base into a jurisdiction where the interest income will be subject to much lower rates of tax are a major driver of corporate expatriations. In their report on the rumored Walgreens inversion, Barclays Bank PLC research analysts estimated that Walgreens could offset just under half of its earnings before interest, taxes, depreciation, and amortization with intercompany interest and not run afoul of the interest deduction limitation rules of section 163(j).<sup>3</sup> They estimated that the tax savings (for one year) would be \$783 million. It is not surprising that Wall Street investment bankers are pushing these deals and that deal activity is reaching a frenzied level.

Companies involved in expatriations from the early 2000s have filed tax court petitions to protect the fruits of their huge leveraging of U.S. operations.<sup>4</sup> There is reason to suspect that the IRS will have mixed success combating this stripping of the U.S. tax base. In 2012 the IRS lost its debt-equity case against ScottishPower Ltd.'s hybrid instrument.<sup>5</sup> In a 2009 Tax Court case, the IRS conceded 100 percent of a huge GlaxoSmithKline PLC deficiency relating to a \$13.5 billion intercompany obligation to GlaxoSmithKline Investments (Switzerland) GmbH.<sup>6</sup>

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discuss this possibility simply because those risks have not been sufficient to deter corporate expatriations.

<sup>3</sup>Meredith Adler and Eric Percher, "Walgreen Co., Investors in the Driver's Seat; Upgrading to Overweight," Barclays Research, at 36 (June 18, 2014) ("Put another way, as much as 50 percent or more of Walgreen's annual adjusted taxable income (which would otherwise be paid as a taxable dividend to the [new foreign] parent) may be effectively exempted from U.S. income taxes by recapitalizing Walgreens with intercompany debt"). See also Americans for Tax Fairness and Change to Win, "Offshoring America's Drugstore, Walgreens May Move Its Corporate Address to a Tax Haven to Avoid Paying Billions in U.S. Taxes" (June 2014), available at <http://walgreenstrategywatch.org/wp-content/uploads/2014/06/OffshoringAmericasDrugstore.pdf>.

<sup>4</sup>All of the former Tyco International Ltd. companies have filed petitions contesting the disallowance of interest expense on intercompany debt. See Matthew Madara, "Tyco Petition Seeks to Avoid Billions in Adjustments," *Tax Notes*, Sept. 2, 2013, p. 976.

<sup>5</sup>*NA General Partnership v. Commissioner*, T.C. Memo. 2012-172.

<sup>6</sup>*GlaxoSmithKline-Kline Holdings (America) Inc. v. Commissioner*, Nos. 18940-08, 18941-08 (T.C. Nov. 18, 2009). See Jasper L. Cummings, Jr., "Income Stripping by Interest Deductions," *Tax Notes*, Dec. 2, 2013, p. 971 ("The IRS knows that the debt/equity argument is messy and hard to win against a taxpayer that has tried to plan around it. For example, in 2009 the IRS conceded 100 percent of a huge deficiency assessment contested by GlaxoSmithKline Holdings in the Tax Court. The debt and the interest paid on it to the foreign parent were pretty obviously a sort of income stripping, which the IRS effectively blessed").

A second major incentive to invert is to lend untaxed offshore controlled foreign subsidiary (CFC) earnings to non-U.S. affiliates (that are not direct or indirect subsidiaries of the former U.S. parent), to repay debt (including debt incurred to make the acquisition), to fund distributions in respect of stock and, indirectly, to make up for funding of the U.S. group.<sup>7</sup> To achieve these tax savings, it is necessary to avoid constructive dividend foot faults,<sup>8</sup> but the case law is quite favorable for taxpayers. With diligence and planning, the tax risks are manageable. The pressure to be able to use untaxed foreign subsidiary earnings held in cash offshore is evidenced by the lengths that Hewlett-Packard Co. went to in trying to circumvent the investment in U.S. property rules of section 956.<sup>9</sup>

Cross-border, related-party debt equity issues need to be addressed in tax reform and, indeed, have been targeted by Camp's tax reform plan and an administration budget proposal. There is clear regulatory authority, however, to address excessive related-party debt under current law. A second major object of a corporate expatriation is to obtain access to offshore cash, earned while the foreign subsidiary was subject to U.S. taxing jurisdiction, without U.S. taxation of the earnings that gave rise to the cash. Clever tax planners use corporate expatriations to insert a foreign parent and use loans to try to hopscotch over or out of the U.S. tax base.<sup>10</sup> Treasury has both conventional regulatory authority and extraordinary multiparty financial regulatory authority to protect against this latest form of avoidance of these rules.

### C. Reduce Expatriation Tax Incentives

**1. Related-party debt-to-equity limitation.** The explicit language of section 385 gives the Treasury secretary direct and powerful regulatory authority to reclassify debt as equity and thereby transform a deductible interest payment into a nondeductible

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<sup>7</sup>Credit Suisse European Pharma Team, Shire + AbbVie 1 (June 24, 2014) ("Reducing the US tax penalty on repatriation of ABBV's overseas earnings is the key driver of the transaction, in our view").

<sup>8</sup>Under the tax law, generally, a corporate action gives rise to a constructive dividend if it confers a specific economic benefit on its shareholder. See generally Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 8.06.

<sup>9</sup>See Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Hearing on Offshore Profit Shifting and the U.S. Tax Code, Exhibit 1, "Memorandum From Chairman Carl Levin and Senator Tom Coburn to Subcommittee Members, Offshore Profit Shifting and the Internal Revenue Code," 24-27 (Sept. 20, 2012), available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>.

<sup>10</sup>Edward D. Kleinbard, "Tax Inversions Must Be Stopped Now," *The Wall Street Journal*, July 21, 2014.

dividend.<sup>11</sup> Under section 385, it is possible and appropriate to identify cases in which the use of related-party debt exceeds thresholds that should be acceptable in a particular case.

A variation of Camp's proposal to limit excess domestic indebtedness for U.S. members of a worldwide affiliated group, and the administration's budget proposal to limit earnings stripping, could be implemented as a regulation under section 385. The target is excessive related-party debt. This debt routinely is subordinated to external debt, directly or structurally. Consequently, two or more of the factors in section 385(b) will be relevant to the analysis of excess domestic indebtedness.<sup>12</sup> One proposal would be described roughly as follows:

A U.S. corporation that is an expatriated entity would classify as equity any debt issued to a foreign member of the expanded affiliated group that is not a CFC to the extent that, at the close of the year of issuance, the U.S. corporation otherwise would have excess U.S. indebtedness. Excess U.S. indebtedness would be determined according to the lesser of the following two amounts:

- The amount by which the total indebtedness of the U.S. members of the expanded affiliated group exceeds 110 percent of the debt those members would hold if their aggregate debt-to-equity ratio were equal to the ratio of debt-to-equity of the expatriated entity's affiliated group, averaged

for the three years prior to the expatriation date and determined without regard to intragroup debt.

- The amount of U.S. corporation debt with respect to which net interest expense of the U.S. corporation would exceed 25 percent of the U.S. corporation's average adjusted taxable income for the three years prior to the year of debt issuance.<sup>13</sup>

If this provision were adopted, Barclays' projected benefit of the Walgreens intercompany debt would be reduced by hundreds of millions of dollars. That would change the calculus of a decision to expatriate, even if it would not change the decision in every case.

Section 385 is not normally thought of as an antiabuse provision (indeed, it has hardly been thought of at all since it was amended in 1992) and this proposal is to apply it to only a subset of related party cases — those involving expatriated entities. The plain language of the statutory provision, however, authorizes its application to a particular factual situation and therefore supports a regulation addressing expatriated entities, which is comparable to a group found by Treasury in 2007 to engage in earnings stripping against which section 163(j) was ineffective.<sup>14</sup>

Why limit this proposal to an expatriated entity? Why not apply it to every foreign parent group? Also, why not extend the use of section 385 to pick up base erosion cases in which interest income on

<sup>11</sup>Section 385(a) provides in relevant part:

Section 385. Treatment of certain interests in corporations as stock or indebtedness

(a) Authority to prescribe regulations. — The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

(b) Factors. — The regulations prescribed under this section shall set forth factors which are to be taken into account in determining *with respect to a particular factual situation* whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

- ...
- (2) whether there is subordination to or preference over any indebtedness of the corporation,
- (3) the ratio of debt to equity of the corporation,
- ..., and
- (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[Emphasis added.]

<sup>12</sup>As a matter of textual statutory interpretation, none of the factors listed in section 385 need to be invoked. The only requirement of the statute is that Treasury set forth factors to take into account a particular factual situation.

<sup>13</sup>Some definitions and rules of application drawn from the various proposals flesh out this approach:

- If the U.S. corporation is a member of a group filing a U.S. consolidated return, the rules would treat the consolidated return participants as a single taxpayer.
- An expanded affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under section 1504, except the ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent and the restriction on inclusion of a foreign corporation under section 1504(b)(3) is disregarded for purposes of identifying the worldwide affiliated group. This is the definition in section 7874(c)(1).
- Net interest expense is the amount of interest paid or accrued in the tax year in excess of the amount of interest includable in gross income for the same tax year, as defined in section 163(j)(6)(B).
- Adjusted taxable income is taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses, and so on as defined in section 163(j)(6)(A).

The regulations would provide antiavoidance rules and rules for the treatment of partnership indebtedness, allocation of partnership debt, interest, or distributive shares.

<sup>14</sup>Treasury, "Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties," at 21-31 (Nov. 2007).



indebtedness is not taxed in the hands of the holder? Both of these ideas, and more, could be adapted to section 385. There is no doubt that a more comprehensive approach to protecting the U.S. tax base would be preferred as a pure policy matter. Since this proposal is intended to be a stopgap measure until the adoption of tax reform, and since rapid adoption is *critical*, I would opt to keep the fix limited to expatriation cases.<sup>15</sup>

**2. Protecting deferred U.S. taxation of CFC earnings.** The U.S. tax rules for deferring U.S. tax on active earnings of CFC subsidiaries generally are conditioned on not using the assets of the foreign subsidiary, directly or indirectly, for the benefit of the U.S. parent.<sup>16</sup> Thus, U.S. rules generally cause foreign subsidiary loans to the U.S. parent, use of foreign subsidiary assets to secure U.S. parent debt, or even foreign subsidiary guarantees of U.S. parent debt as deemed distributions of the untaxed earnings. The policy behind these rules is that CFC earnings that have not been subject to U.S. taxation should not be allowed to be used on a pretax basis for the benefit of the U.S. parent or its U.S. affiliates.

The insertion of a foreign holding company in a corporate expatriation should not allow the use of untaxed foreign subsidiary earnings outside the scope of current or future U.S. corporate tax and circumvent the U.S. tax system. This tax avoidance purportedly is accomplished by lending CFC earnings that have not been taxed by the United States to the new foreign parent or non-CFC members of the group or, over time, by decontrolling the CFC so as to take the CFC outside the scope of the U.S. rules for taxing these earnings.

In a corporate expatriation transaction, shareholders of the former U.S. parent company transfer their shares in exchange for shares of the new foreign parent company.<sup>17</sup> For the transaction to be covered by section 7874, the former shareholders of the expatriated U.S. parent must own between 60 and 80 percent of the new foreign parent.<sup>18</sup> The CFC

subsidiaries of the expatriated U.S. company continue to be subject to the deferred U.S. tax rules (as long as they are not decontrolled). Regulatory authority could be used to ensure that the inversion is not used to gain access to earnings that should be subject to deferred U.S. tax in companies that are not owned by the expatriated U.S. companies. This would protect the deferred U.S. taxation of untaxed CFC earnings and the integrity of section 956 rules for investments in U.S. property.

Multiple sources of regulatory authority may apply, individually or in combination, to support application of section 956 to corporate expatriation tax avoidance schemes. These provisions include sections 956(e), 7701(l), and 7874(g),<sup>19</sup> as well as section 7805.<sup>20</sup>

In the corporate expatriation context, the surrogate foreign corporation is inserted between the former shareholders and former U.S. parent (as part of an acquisition of a foreign target). If (i) a subsidiary of the former U.S. parent makes a loan to the new foreign parent (or a member of its group), and (ii) the new foreign parent (or a member of its group) makes a loan to the former U.S. parent (or any expatriated U.S. entity), the CFC should be considered to be financing, directly or indirectly, the loan to the U.S. person. In this intercompany loan case, the CFC loan should be considered made to an

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Location: An Essay on Mobility's Place in Optimal Taxation," 63 *Nat. Tax J.* 843, 856 (2010). The acquisition of a real asset should not immunize the tax avoidance part of the transaction, which is the use of a new holding company to avoid the use of CFC earnings for the benefit of the former U.S. parent (or its shareholders).

<sup>19</sup>Section 956(e) provides:

(e) Regulations.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section *through reorganizations or otherwise*. [Emphasis added.]

Section 7701(l) provides:

(l) Regulations relating to conduit arrangements.—The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such *recharacterization is appropriate to prevent avoidance of any tax imposed by this title*. [Emphasis added.]

Section 7874(g) provides in part:

(g) Regulations.—The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for *such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section*. [Emphasis added.]

<sup>20</sup>The regulatory approaches described in this note do not exhaust the regulatory authority alternatives. Other provisions that could be looked to include sections 7701(o) and 269.

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<sup>15</sup>As a practical matter of political economy, a broader proposal would attract enormous lobbying by foreign parent groups and their trade associations (such as the Organization for International Investment). There will be enough time consumed by lobbyists for representatives of U.S. multinationals.

<sup>16</sup>See generally section 956 and regulations thereunder.

<sup>17</sup>If there is sufficient continuing ownership, the new foreign parent is classified as a "surrogate foreign corporation." The former U.S. parent and some related U.S. persons are the expatriated entities.

<sup>18</sup>In other words, as part of the expatriation transaction, the former U.S. parent acquires a foreign company whose equity value is at least 20 percent of the combined company. This is a meaningful transaction. It nonetheless is an example of what Joel Slemrod dubs the "avoidance-facilitating effect" of real decisions. See Joel Slemrod, "Location, (Real) Location, (Tax)

(Footnote continued in next column.)

expatriated U.S. entity and be analyzed as an investment in U.S. property. This would be a fairly straightforward use of section 7701(l) regulatory authority.

What if a CFC subsidiary lends funds to the new foreign parent and the new foreign parent buys back stock from its shareholders? The loan to the new foreign parent is hopscotching over the former U.S. parent and not returning to the U.S. parent. However, the buyback has the same effect as if the CFC made the loan to the U.S. parent to buy back its stock (before the acquisition) and then distributed the repayment obligation to the new foreign parent (after the acquisition). Alternatively, it has the same effect as a loan to the new foreign parent to acquire shares in the former U.S. parent.<sup>21</sup> In either case, the asset is in the hands of the new foreign parent and not the U.S. parent, but the untaxed earnings are indirectly used to acquire stock in the former U.S. parent. Although not as clear as in the intercompany loan case, the combined authority of sections 956(e) and 7701(l) could support treating the loan as an investment in U.S. property.

The following proposal, again described in rough preliminary language, could be adopted under the regulatory authority of the sections described above:

If the assets of a CFC subsidiary of the former U.S. parent (an expatriated entity) are used to make a loan to the new foreign parent (i.e., the surrogate foreign corporation) or a non-CFC subsidiary thereof, and either (i) the surrogate foreign corporation makes a distribution to its shareholders in redemption of its stock (within a time period to be specified), or (ii) within the applicable period (defined in section 7874(d)(1) as 10 years from the corporate expatriation) the surrogate foreign parent or a member of its expanded affiliated group that is not a CFC holds an obligation of the former U.S. parent or a member of its affiliated group, the loan by the CFC should be treated as U.S. property under section 956(c).

This approach would use the section 956 rules to operate in respect of untaxed CFC earnings and profits hopscotched around the U.S. parent to non-CFC foreign affiliates when loans are made to (U.S.) expatriated entities or stock is bought back from shareholders.

<sup>21</sup>If the loan is used to buy back shares of the foreign parent that were issued to shareholders of the foreign target, there could be a separate question of how those shares should be treated for purposes of section 7874, but that is beyond the scope of this discussion.

## D. Evaluation of Regulatory Action

**1. Overview.** The obvious advantage of taking regulatory action is the ability to act quickly. That is especially important because more and more companies are planning or seeking transactions that take advantage of apparent statutory loopholes. One banker has told me he expects the volume of deals to be announced in September of this year to be double the volume of deals announced in June and July. The alternatives suggested above do not prohibit corporate expatriation transactions, but they would change the tax calculus of having a non-U.S. parent in relation to use of earnings-stripping intercompany debt and CFC earnings.<sup>22</sup>

The exercise of regulatory authority changes the default position. Instead of waiting for Congress to act and relying on the market to deal with the risk of losing the corporate tax base in the meantime (in hopes there would be an inadequate supply of foreign targets<sup>23</sup> or the price or risk of acquiring foreign targets goes too high), adopting regulations first would reduce the risk to the U.S. corporate tax base while Congress considers how to address the problem in legislation as part of tax reform or otherwise.

A second advantage is that regulatory action also may reduce tax benefits to companies that have already undertaken tax-motivated expatriations. It is appropriate to limit, as much as is possible under the rules of section 7805, the fruits of abusive tax-motivated transactions.

**2. Revenue and politics.** The Stop Corporate Inversions Act of 2014 is estimated by the Joint Committee on Taxation to raise \$19.5 billion over 10 years. A regulatory change is not treated as raising revenue until revenue is received (that is, loss of revenue does not occur). It does not have the benefit of making available a revenue offset for Congress to

<sup>22</sup>As discussed above, non-U.S.-parent groups have inappropriate advantages in reducing the U.S. corporate tax base. These proposals should apply to foreign parent groups as well as to expatriation cases; however, for reasons discussed above, more comprehensive proposals could be adopted later or as part of tax reform.

<sup>23</sup>The incentives for managements and bankers are to do deals. Investment bankers have been generating lists of potential foreign targets that suggest the supply is ample for some time. The Abbott Laboratories-Mylan "spinversion" suggests that there are a very large number of potential targets within the portfolio of foreign assets of existing U.S. multinationals. Companies that already have expatriated are begetting additional potential foreign targets. Each of the following inverted companies has engaged in spinoffs of companies at least one of which has become a target: Tyco (split into three companies, including Covidien PLC, a target of Medtronic Inc.), Covidien (a former Tyco company has spun off Mallinckrodt Pharmaceuticals), and Nabors Industries Ltd.

use for an alternative purpose. This is not a principled reason to forgo a regulatory change if a legislative change is unfeasible. For purposes of the country's fiscal health, the prevention of revenue loss by a regulatory change is the same as if implemented by statute.

The politics of a change are speculative. It is hard to find many people outside Wall Street (and Abbott Laboratories<sup>24</sup>) who think tax-motivated corporate expatriations are a good thing, but that's not the end of the political calculus. Some politicians may believe this is a good issue with which to attack their opponents for failing to adopt legislation. Others may believe the administration is the loser if there is a failure to act legislatively. Some may think politicians from both parties are losers if there is a failure to address the issue. The latter group should welcome Treasury action if Congress is incapable of acting. Others may oppose regulatory action for fear that President Obama would get credit. Some might object to any action out of a preference for smaller government (which rests on the heroic assumption that expenditures will be reduced instead of debt financed).

Irrespective of one's political calculus, the policy question is how much risk to U.S. welfare there is from inaction in relation to cost from regulatory action. If the risks outweigh the costs, action is called for. Even acknowledging my revenue loss aversion bias, regulatory action is called for in the current circumstances.

**3. Intercompany debt.** Congress has addressed debt-equity issues in recent years by limiting deductions for interest, rather than classifying an instrument as debt or equity. An advantage of deduction limitation approaches is that they generally have a self-adjustment mechanism so that if circumstances of the debt issuer change, greater or lesser interest deductions are allowed. In contrast, the U.S. practice generally has been to classify a debt instrument on issuance and to retain that classification. This is clunky and generally requires a taxpayer to issue a new instrument in order to change the classification. Classification as equity not only eliminates the interest deduction, it also causes cross-border payments qualifying as dividends to be subject to withholding tax. The proposal described above is limited to intercompany indebtedness within an expanded affiliated group

so the taxpayer controls the amount of intercompany debt and its consequences. The clunkiness should be manageable.<sup>25</sup>

It is important to understand that even if the United States were to lower its corporate tax rate and adopt a territorial approach to exempting foreign business income, there would be incentives to strip the U.S. tax base — many of which would be identical to the incentives that exist under the current regime. The structural changes in the proposals described above would remain important after those reforms as well as under current law. Moreover, this brief discussion does not address the use of intangibles and other devices to strip the U.S. tax base. Proposals to address those abuses also are needed, but they simply are not as important in affecting the calculus of boardrooms that are considering corporate expatriations as intercompany debt and use of offshore cash. A person involved in many deals estimates that without these two incentives, 75 percent of the deals in process would not happen.

**4. Combating avoidance of deferred U.S. taxation.** Companies considering expatriating have earned income deferred from U.S. tax and now want to avoid the tax. Congress has accorded Treasury extraordinary authority to pursue complicated international structures that sidestep U.S. tax rules, including the rules under section 956 designed to prevent use of deferred offshore earnings on a pretax basis for the benefit of the U.S. company. This authority has been used numerous times and often aggressively. Congress over the years has clearly indicated that it does not support tax-motivated corporate expatriations. Inserting a new foreign parent company should not be allowed as a means of sidestepping rules that protect the deferred U.S. tax on untaxed earnings.

Failing to act on this dimension will make future tax reform even harder. If corporate expatriations continue at a breakneck pace, there will be further divisions in the business community regarding those who have already avoided U.S. tax on their CFC earnings and those that would have to pay the toll charge that in all of the tax reform proposals is a condition to shifting to a foreign exemption

<sup>24</sup>Myles White, "Ignoring the Facts on Corporate Inversions: Don't Believe Absurd Claims About Companies Abusing the Tax Code or Being Unpatriotic," *The Wall Street Journal*, op-ed (July 17, 2014), available at <http://online.wsj.com/articles/miles-d-white-ignoring-the-facts-on-corporate-inversions-1405638376?KEYWORDS=Miles+White>.

<sup>25</sup>Indeed, as David Rosenbloom has observed, treating a group member as a creditor for tax purposes is a legal fiction with little substance. H. David Rosenbloom, "Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt," 26 *Sydney Law Rev.* 17 (2004) ("There seems to be only one serious problem with related party debt: by most standards of economics, 'substance,' or common sense, it is not debt. That is, related party debt is generally not compensation for money lent by one person to another. Rather, it is a transfer of funds from one incorporated pocket to another, usually for tax-reduction purposes"), available at <http://www.austlii.edu.au/au/journals/SydLRev/2004/2.html#Heading87>.



system. This is just one reason why Congress should encourage the administration to take the steps outlined above.

### E. Conclusion

The proposed regulatory changes would materially reduce the incentive for a U.S. corporation to expatriate for tax-motivated reasons by reducing the cash and book tax benefits from expatriating. These approaches would not prevent cross-border combinations that are grounded on real business objectives. They are supported by existing statutory authority and integrate well with future tax reform. Most important, they would stanch the rush to the exit that is motivated by loopholes in our existing tax rules and increase the ability to work toward real international tax reform in the future. Without action, there may be little corporate tax base to reform.

The U.S. Treasury raises more revenue than any other institution in the world. The tax system that accomplishes this task requires constant attention and protection — market forces cannot be relied upon to fix problems. Without tax revenue, the public goods the federal government provides cannot be purchased, vital income transfers cannot be made, and individuals suffer as a result. When corporations do not pay their share, other taxpayers have to make up the difference. Failing to address tax-motivated corporate expatriations risks real damage to the U.S. tax structure. The tools are available; it is time to use them.

## Petaluma and the Limits Of Treasury's Authority

By Andy S. Grewal

Andy S. Grewal is an associate professor at the University of Iowa College of Law. He welcomes comments at [agrewal@iowa.uiowa.edu](mailto:agrewal@iowa.uiowa.edu).

In this article, Grewal examines the fundamental administrative law questions raised in *Petaluma v. Commissioner*, pending before the D.C. Circuit.

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In *United States v. Woods*,<sup>1</sup> the Supreme Court seemingly resolved a jurisdictional issue and a penalty issue regarding son-of-BOSS transactions involving partnerships.<sup>2</sup> On the jurisdictional issue, the Court held that section 6226(f) allows a TEFRA court to consider the application of the gross valuation misstatement penalty to the inflation of outside basis in a sham partnership.<sup>3</sup> The Court also seemingly resolved the substantive penalty issue, concluding that the gross valuation misstatement penalty applies to the inflation of outside basis in a sham partnership.

However, as I have previously explained, the Court's opinion does not definitively resolve either issue.<sup>4</sup> On the jurisdictional issue, the parties failed to present a threshold regulatory question that could preclude a TEFRA court from considering any aspect of a case involving a sham partnership. On the penalty issue, the Court itself doubted the validity of reg. section 1.6662-5(g), which extends the gross valuation misstatement penalty to zero basis circumstances.<sup>5</sup> But because the taxpayers in

<sup>1</sup>134 S. Ct. 557 (2013).

<sup>2</sup>For analysis of the bond and option sales strategy transaction and its variants, see Karen C. Burke and Grayson M.P. McCouch, "COBRA Strikes Back: Anatomy of a Tax Shelter," 62 *Tax Law.* 59 (2008).

<sup>3</sup>"TEFRA court" does not refer to any special type of federal court, but rather to a court that is conducting a partnership-level proceeding under the procedures established by the 1982 Tax Equity and Fiscal Responsibility Act, P.L. 97-248, 96 Stat. 324 (1982).

<sup>4</sup>See Andy S. Grewal, "The Missed Jurisdictional Argument in *United States v. Woods*," 33 *BNA Tax Management Weekly Rpt.* 100 (2014), available at <http://tinyurl.com/WoodsJurisdiction>.

<sup>5</sup>See reg. section 1.6662-5(g) ("The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent"). For a sham partnership, each partner's outside basis is zero.